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May 20, 2009

Via E-Mail

Assembly Member Ed Hernandez
State Capitol
P.O. Box 942849
Sacramento, CA 94249-0057

Re: AB 1743

Dear Assembly Member Hernandez:

I am writing to express my opposition to AB 1743 in its current form. Although I recognize that the use of placement agents to obtain business from public retirement systems is an important issue, the bill confuses the very different situations in which placement agents are used.

By way of background, I previously served as California's Commissioner of Corporations, Interim Savings & Loan Commissioner, and Deputy Secretary and General Counsel of the Business, Transportation & Housing Agency. I am a former member of the California Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions. I also previously served as Co-Chairman of the Corporations Committee of the Business Law Section of the California State Bar and Chairman of the Business & Corporate Law Section of the Orange County Bar Association. For the last several years, I have served as an Adjunct Professor of Law at Chapman University School of Law. I am a practice consultant to the leading treatise on California's securities laws, Marsh & Volk, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS. Please note, however, I am writing solely in my individual capacity.

Background

Placement agents are currently used by two different categories of persons seeking retirement system business: investment managers and investment vehicles.

Investment Managers. In the first situation, an investment manager may use a placement agent to obtain investment management services from a retirement system. The California Public Employees Retirement System ("**CalPERS**"), for example, has about one half of its public equity investments managed by external investment managers. These investment managers are selling their expertise in managing securities portfolios rather than a particular investment. In this letter, I refer to this type of external manager as an "**Investment Manager**".

Investment Managers generally must be registered as investment advisers with the Securities and Exchange Commission (the "**SEC**") or the California Department of Corporations (the "**DOC**").[1] If an Investment Manager is registered with the SEC, the Investment Manager's use of placement agents is subject to the SEC's "**Solicitor's Rule**", Rule 206(4)-3 under the Investment Advisers Act of 1940 (the "**Advisers Act**").[2] Under this rule, registered investment advisers may pay cash compensation to others to seek out new clients on their behalf, commonly called "solicitors" or "finders," if they meet the following conditions:

- The solicitor is not subject to specified disciplinary actions.
- The fee is paid pursuant to a written agreement to which the adviser is a party and (with limited exceptions) the agreement must: describe the solicitor's activities and compensation arrangement; require that the solicitor perform the duties assigned by the adviser and in compliance with the Advisers Act; require the solicitor to provide clients with a current copy of the adviser's disclosure document; and, if seeking clients for personalized advisory services, require the solicitor to provide clients with a separate written disclosure document containing specific information.
- The adviser must receive from the solicited client, prior to or at the time the adviser enters into an agreement, a signed and dated notice confirming that the client was provided with adviser's disclosure document and, if required, the solicitor's disclosure document.
- The adviser must have a reasonable basis for believing that the solicitor has complied with the terms of agreement with the adviser.

Last year, the SEC proposed a new rule under the Advisers Act that is specifically intended to address "pay-to-play" practices by SEC registered investment advisers.[3] The proposed rule would:

- Prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates.
- Prohibit an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser.
- Prevent an adviser from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties when the adviser is providing or seeking government business.
- Require a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees.

In 2007, the California Commissioner of Corporations proposed to adopt a rule applicable to state registered investment advisers that would substantially mirror the SEC's current Solicitor's Rule. This rulemaking proposal by the DOC is still pending.

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[1] In 1996, Congress divided authority to regulate investment advisers between the states and the SEC pursuant to the National Securities Markets Improvement Act. As a result, the SEC regulates larger investment advisers while the states regulate smaller investment advisers.

[2] 17 C.F.R. §275.206(4)-3.

[3] SEC Release No. IA-2910 (Aug. 3, 2009).

Vehicle Managers. Public retirement systems also invest in various investment vehicles. Typically, these investments take the form of limited partnerships or limited liability companies. These investment vehicles in turn may acquire and deal in securities or other assets directly or they may invest in a pooled investment vehicle. In the latter situation, the investment vehicle would be a feeder to the ultimate investment vehicle. A general partner or manager typically manages the investment vehicle. In most cases, the general partner or manager will be responsible of the initial organization of the investment vehicle and the sale of investment interests in it. In this letter, I refer to these managers as "**Vehicle Managers**". Vehicle Managers may use placement agents to assist them in selling an investment in the investment vehicle to a public retirement system.

The offer and sale of limited partnership and membership interests are subject to federal and state securities laws. Additionally, a person who is engaged in the business of effecting transactions in securities for the account of others is considered a "broker" under the Securities and Exchange Act of 1934 (the "**Exchange Act**") and a "broker-dealer" under the California Corporate Securities Law of 1968 (the "**CSL**").[4] Unless exempt, therefore, a person hired by a Vehicle Manager to help place investments will in many cases be subject to licensing and regulation under both the Exchange Act and the CSL as a securities broker-dealer.[5] The Vehicle Manager may also meet the definition of an "investment adviser" under the Advisers Act and the CSL. Often, however, a Vehicle Manager will be exempt from registration pursuant to Section 203(b)(3) of the Advisers Act and Rule 260.204.9 of the Commissioner's rules under the CSL.

In summary, placement agents are used by two distinct categories of persons seeking to do business with public retirement systems – Investment Managers and Vehicle Managers. These differences are summarized in the table below.

Investment Manager	Vehicle Manager
Investment Manager manages a portfolio of securities or other assets	Vehicle Manager manages an investment vehicle
Investment Manager is typically registered with the SEC or a state as an investment adviser	Vehicle Manager may not be registered with either the SEC or a state as an investment adviser
The retirement system is a client of the Investment Manager	The retirement system is not a client of the Vehicle Manager
Retirement system purchases advisory services from the Investment Manager	Retirement system purchases a security from the investment vehicle
Solicitor's Rule applies to cash payments to third persons for soliciting clients	Solicitor's Rule does not apply to cash payments to third persons for soliciting investors

[4] Exchange Act § 3(a)(4) and Cal. Corp. Code § 25004. Although the Vehicle Manager may be registered with the SEC as an investment adviser, the SEC staff has taken the position that the Solicitor's Rule does not apply to a cash payment solely to compensate that person for soliciting investors for, or referring investors to, a pooled investment vehicle. Mayer Brown LLP, SEC No-Action Letter (July 28, 2008) available at: http://www.sec.gov/divisions/investment/noaction/2008/mayerbrown072808-206.htm.

[5] Recently, the California Attorney General filed suit against two individuals and a company alleging, among other things, that they were unregistered broker-dealers. In this letter, I am expressing no opinion concerning the merits of these allegations.

AB 1743 Fails to Distinguish Between Investment Managers and Vehicle Managers

AB 1743 defines "external manager" as "an asset management firm that is seeking to be, or has been, retained by a public retirement system in California to manage a portfolio of assets, including securities, for a fee."[6] Thus, the definition of "external manager" is limited only to persons who provide investment management services – that is, Investment Managers as I've described them above. The definition does not reach Vehicle Managers because Vehicle Managers manage the investment vehicle.

However, the proposed definition of "placement agent" contemplates the use of placement agents by Vehicle Managers in connection with the offer and sale of investments to a public retirement system.[7] Proposed Section 82047.3 defines a "placement agent" to mean an individual "hired, engaged, or retained by, or acting on behalf of, an external manager, or on behalf of another placement, agent, to act . . . as a finder, solicitor, marketer, consultant, broker, or other intermediary to raise money or investment from, or obtain access to, a state public retirement system in California, directly or indirectly, including, without limitation, through an investment vehicle."[8]

The proposed legislation is further confused by the proposed definition of "investment vehicle".[9] That definition refers to a partnership, limited partnership, limited liability company, or other investment vehicle managed by an external manager in which a public retirement system in California is the majority investor and that is organized in order to invest in other external managers. The requirement that the investment vehicle be organized in order to invest in other external managers would seem to evidence an intent to limit the application of the legislation to only those situations in which a retirement system is investing in a "feeder" investment vehicle.

The net effect is that the bill clearly contemplates Investment Managers when it defines "external manager" and then just as clearly contemplates Vehicle Managers when it defines "placement agent". Thus, there is a fundamental disconnect between the key definitions used in the bill. In fact, the definition of "placement agent" does not even directly refer to the use of a placement agent to market investment management services.[10] These definitions should be amended so that the statute clearly delineates who is and who is not covered.

The Proposed Exception for Employees and Others Who Spend One-Third or More of Their Time Managing the Assets Controlled by the External Manager is Unclear and Confusing.

AB 1743 would exclude an employee, officer, director, equityholder, partner, member, or trustee of an external manager from the definition of a "placement agent" if that person spends "one-third or more of his or her time, during a calendar year, managing the assets controlled by the external manager".[11] This proposed exclusion most clearly applies to persons who hold a specified position with an external manager that is an Investment Manager. There are two reasons for this. First, as discussed above, the definition of "external manager" encompasses Investment Managers but not Vehicle Managers. Second, Vehicle

[6] See proposed Govt. Code § 82025.3. While I recognize that this definition is the same as that found in current Govt. Code § 7513.8(b) enacted last year (AB 1584, Cal. Stats. 2009 ch. 301), that definition suffers from the same deficiency and should be reformed as well.

[7] Again, I recognize that this same language was adopted by the Legislature last year as part of AB 1584. See Govt. Code § 7513.8(c).

[8] AB 1743 would add a definition of "investment vehicle" to current Govt. Code § 7513.8 and include the same definition in proposed Govt. Code § 82047.3.

[9] Proposed Govt. Code §§ 7513.8(c)(3) & 82047.3(d).

[10] At best, this is only implied by the vague reference to "obtaining access to".

[11] Proposed Govt. Code §§ 7513.8(c)(2) & 82047.3(b).

Managers typically manage an investment vehicle such as a limited partnership or limited liability company. The proposed exclusion would be clearer if it applied to persons who spend time managing the assets or the investment vehicle.

The Proposed Exception for In-House Sales Employees, Officers or Directors is Unclear and Confusing.

AB 1743 would exclude from the definition of a "placement agent" an in-house sales employee, officer or director of an external manager who is, among other things, "registered with the Securities and Exchange Commission".[12] This provision is unclear in at least two respects.

First, the proposed legislation is unclear concerning whether it is the external manager or its employee, officer or director that must be registered with the SEC.

Second, it is unclear what the legislature intended by use of the term "registered". If the external manager is an Investment Manager, it will most likely be registered with *either* the SEC or a state securities regulator, such as the DOC, as an investment adviser. If the external manager is an investment adviser registered with the SEC, its employees, officers and directors typically would not also be registered with the SEC as investment advisers. If the external manager is a Vehicle Manager, it may or may not be registered with either the SEC or a state as an investment adviser. In addition, Vehicle Managers are typically not subject to registration as securities brokers with the SEC. Finally, employees of Vehicle Managers who participate in the distribution of securities issued by the investment vehicle often rely on SEC Rule 3a4-1 which excludes persons associated with an issuer from broker-dealer registration under the Exchange Act.

Conclusion

While AB 1743 addresses an issue of public interest, it fails to take account of key distinctions in the types of persons who may use placement agents to obtain business or funding from retirement systems. I oppose enactment of AB 1743 unless the bill is amended to fix the problems that I've described above. If you or your staff should have any questions regarding the foregoing, please do not hesitate to contact me.

Sincerely,

Keith Paul Bishop

cc: Assembly Member Jeff Miller (via email)
Preston DuFauchard, Commissioner of Corporations (via email)
Anne Stausboll, California Public Retirement System (via email)
Colleen Monahan, Deputy Commissioner, California Department of Corporations (via email)
Diane Stanton, Director of Legislation, State Treasurer's Office (via email)

[12] Proposed Govt. Code § 82047.3(c). This exclusion is not included in Govt. Code § 7513.8. Thus, it is possible that a person is excluded from the definition of a lobbyist and yet will be required by Govt. Code § 7513.86 to be registered as a lobbyist.